

**Technical Explanation of Bill to
Amend the Internal Revenue Code of 1986 to
Disallow the Deduction for Excess Nontaxed Reinsurance Premiums
Paid to Affiliates**

Present Law

Insurance companies in general

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to tax at regular corporate income tax rates.

Property and casualty insurers

Under present law, the taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832). For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners (sec. 832(b)(1)(A)).

Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred (sec. 832(b)(3)). Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). Present law provides for the discounting of the deduction for loss reserves to take account partially of the time value of money (sec. 846). Thus, present law limits the deduction for unpaid losses to the amount of discounted unpaid losses. Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

The discounted reserves for unpaid losses are calculated using a prescribed interest rate that is based on the applicable Federal mid-term rate (“mid-term AFR”). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain “long-tail” lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using

aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

Reinsurance premiums deductible

In determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance (sec. 832(b)(4)(A)).

Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year (sec. 832(b)(4)(B)). The company is required to reduce the deduction for increases in unearned premiums by 20 percent. This amount serves to represent the allocable portion of expenses incurred in generating the unearned premiums, so as to provide a degree of matching of the timing of inclusion of income and deduction of associated expenses.

Proration of deductions relating to untaxed income

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns (sec. 832(b)(5)). This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

Treatment of reinsurance

In general

Present law includes a rule enacted in 1984 providing authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion (sec. 845).¹

The rule permits the Treasury Department to make reallocations in related party reinsurance transactions. The provision was amended in 2004 to provide the Treasury Department with authority to allocate among the parties to a reinsurance agreement or to recharacterize income (whether investment income, premium, or otherwise), deductions, assets,

¹ Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

reserves, credits, and any other items related to the reinsurance agreement, or to make any other adjustment to reflect the proper source, character, or amount of the item.² In expanding this authority to the amount (not just the source and character) of any such item, Congress expressed the concern that “reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons,” and that “foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base.”³

The provision also provides that if the Secretary determines that a reinsurance contract between insurance companies, whether related or unrelated, has a significant tax avoidance effect on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. The legislative history provides that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, appropriate factors for the Treasury Department to take into account are (1) the duration or age of the business reinsured, which bears on the issue of whether significant economic risk is transferred between the parties, (2) the character of the business (as long-term or not), (3) the structure for determining potential profits, (4) the duration of the reinsurance agreement, (5) the parties rights to terminate and the consequences of termination, such as the existence of a payback provision, (6) the relative tax positions of the parties, and (7) the financial situations of the parties.⁴

Reinsurance premiums received by foreign persons

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States (sec. 882). Such income may be derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. For this purpose, deductions are allowed only if and to the extent that they are connected with the income that is effectively connected with the conduct of a trade or business within the United States. In addition, foreign persons generally are subject to U.S. tax withheld at a 30-percent rate on certain gross income (such as interest, dividends, rents, royalties, and premiums) derived from U.S. sources (sec. 881).

A foreign company carrying on an insurance business in the United States that would be treated as a life insurer or a property and casualty insurer for Federal tax purposes if it were a domestic corporation is subject to U.S. tax under subchapter L on its income effectively connected with its conduct of any trade or business within the United States (sec. 842). Special

² Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

³ See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05, May 2005, 351.

⁴ Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), at 1063-4. In *Trans City Life Insurance Company v. Comm'r*, 106 T.C. 274 (1996), *nonacq.*, 1997-2 C.B. 1, the Tax Court held that two reinsurance agreements did not have significant tax avoidance effects, based on the application of these factors.

rules apply to calculate the minimum effectively connected net investment income for this purpose (sec. 842(b)).⁵ Other U.S.-source income of such a foreign company carrying on an insurance business in the United States is subject to the 30-percent gross-basis withholding tax applicable generally to U.S.-source income of any foreign corporation.

Treasury regulations provide, however, that insurance premiums subject to the insurance or reinsurance excise tax (described below) are not subject to the 30-percent gross-basis withholding requirement applicable for income tax purposes.⁶

Insurance and reinsurance excise tax

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks (secs. 4371-4374). The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty.⁷ The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Exemption from the excise tax

The United States has entered into comprehensive income tax treaties with more than 50 countries, including a number of countries with well-developed insurance industries such as Barbados, Germany, Switzerland, and the United Kingdom. The United States has also entered into a tax treaty with Bermuda, another country with a significant insurance industry, which applies only with respect to the taxation of insurance enterprises.⁸

⁵ In *North West Life Assurance Co. of Canada v. Comm'r*, 107 T. C. 363 (December 12, 1996), the Tax Court held that the business profits article of the United States-Canada income tax treaty permits a Canadian insurer doing business in the United States through a U.S. permanent establishment to attribute income to the permanent establishment based on its “real facts,” not under the minimum investment income calculation of section 842(b).

⁶ Treas. Reg. sec. 1.1441-2(a)(7); *see also* Treas. Reg. sec. 1.881-2(b).

⁷ As further described below, U.S. tax treaties that provide a waiver or exemption of the insurance excise tax generally include an anti-conduit rule to prevent third-country residents from taking advantage of the treaty exemption.

⁸ The U.S.-Bermuda treaty generally exempts from U.S. taxation the business profits of a Bermuda insurance enterprise from carrying on the business of insurance (including insubstantial amounts of income incidental to such business), unless the insurance enterprise carries on business in the United States through a U.S. permanent establishment. For the purposes of the treaty, an insurance enterprise is defined as an enterprise whose predominant business activity is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.⁹ To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).¹⁰

The U.S. tax treaties with Barbados and Bermuda also provide an exemption from the excise tax, although the Senate's ratification of the U.S.-Bermuda treaty was subject to a reservation with respect to the treaty's application to the excise tax. Moreover, section 6139 of the Technical and Miscellaneous Revenue Act of 1988 provides that neither the U.S.-Barbados nor the U.S.-Bermuda treaty will prevent imposition of the excise tax on premiums, regardless of when paid or accrued, allocable to insurance coverage for periods after December 31, 1989.¹¹ Accordingly, no exemption from the excise tax is available under those two treaties with respect to premiums allocable to insurance coverage beginning on or after January 1, 1990.

Earnings stripping rules

A foreign parent corporation with a U.S. subsidiary may seek to reduce the group's U.S. tax liability by having the U.S. subsidiary pay deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although the United States generally subjects foreign corporations to a 30-percent withholding tax on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently,

investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business. The treaty also includes a mutual assistance provision.

⁹ Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

¹⁰ In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that reinsurance premiums paid by one foreign insurer or reinsurer to another foreign reinsurer are subject to the excise tax, unless the second foreign reinsurer issuing the policies is itself entitled to an exemption from the excise tax under an income tax treaty. Further, under the Revenue Ruling, the excise tax applies in the situation in which a foreign insurer or reinsurer entitled to an excise tax exemption under the applicable treaty reinsures with a foreign reinsurer not entitled to an exemption from the excise tax under that treaty. In contrast, under the Revenue Ruling, if a foreign insurer or reinsurer entitled to applicable treaty benefits reinsures with another foreign reinsurer not entitled to an exemption from the excise tax under an income tax treaty, the premiums paid on the underlying policies will not become subject to the excise tax unless such policies were entered into as part of a conduit arrangement.

¹¹ Pub. L. No. 100-647.

foreign-owned U.S. corporations may seek to use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.¹²

Present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. A deduction for “disqualified interest” paid or accrued by a corporation in a taxable year is generally disallowed if two threshold tests are satisfied: the payor’s debt-to-equity ratio exceeds 1.5 to 1 (the so-called “safe harbor” ratio); and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income” (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).¹³ Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt (“guaranteed debt”). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor’s net interest expense) can be carried forward three years.

The earnings stripping rules generally apply to interest, but do not apply to insurance or reinsurance premiums.

Reasons for Change

Primary insurers have a variety of reasons for reinsuring some of their business. A principal reason is to shift risk, just as any other insured does, because an insurer’s pool of risks is too concentrated. There may also be economies of scale in managing risk through reinsurance that may make it attractive to use reinsurance to consolidate the risks of an affiliated group in one entity, before subsequently shifting the risk to third parties or managing risk within the group.

Another reason relates to regulatory compliance. State insurance rules generally require that an insurance company maintain surplus, and the States limit the amount of new business the company can write based on a ratio of net premiums to surplus. Reinsuring some of the company’s risks can lower the ratio of net premiums¹⁴ to surplus and allow the company to write

¹² For example, it appears that the U.S.-Barbados income tax treaty was used to facilitate earnings stripping arrangements in the context of corporate inversions. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and Barbados* (JCX-55-04), September 16, 2004, at 12-20, 22.

¹³ Sec. 163(j).

¹⁴ The amount of net premiums for this purpose is determined net of premiums ceded to a reinsurer. Under State regulation, a ceding company treats amounts due from reinsurers as assets or reductions of liability, an accounting practice known as credit for reinsurance. See Joseph Sieverling and

more insurance. Thus, reinsurance can serve in effect as a form of financing for growth in the primary insurance company's business.

A primary insurer can use reinsurance to reduce exposure to extremely large losses from one source such as a catastrophic event (for example, a hurricane) or a particular environmental hazard (for example, asbestos). By reinsuring amounts above a certain level, the primary insurer can smooth loss payments over the year or between years. This can reduce volatility in the company's earnings.

A reinsurance transaction can also function as a business acquisition technique for the reinsurer. By reinsuring a block of business, for example, a reinsurer can enter a new line of business more easily than by directly writing policies in that line of business. Similarly, a primary insurer can divest itself of a line of business by reinsuring its entire book of business in that line.¹⁵

In addition to these reasons to engage in a reinsurance transaction, there may be particular reasons in the case of related party reinsurance. The transaction can serve to move capital within a group of related parties, or to consolidate capital in a central location to maximize its efficient management. Further, the parties may know more about each other than in the case of unrelated parties, which can reduce the costs of the transaction.

The related party reinsurance transaction can have U.S. tax benefits as well as book or financial benefits. In general, premiums ceded for reinsurance are deductible in determining a company's Federal income tax.¹⁶ If the transaction effects a transfer of reserves and reserve assets to the reinsurer, the tax liability for earnings on those assets generally is shifted to the reinsurer as well. If earnings on these assets are shifted to a related foreign reinsurer, the earnings generally are not subject to U.S. income taxation and could be untaxed (if the related foreign reinsurer is in a no- or low-tax foreign jurisdiction).

The transfer of U.S. risks to foreign affiliates in low-tax or no-tax jurisdictions through reinsurance transactions has been criticized as causing a tax-induced competitive disadvantage for U.S. insurers and reinsurers.¹⁷ The issue has been publicized repeatedly in recent years¹⁸

Scott Williamson, "The U.S. Reinsurance Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004) at 126.

¹⁵ See Donald A. McIsaac and David F. Babbel, "The World Bank Primer on Reinsurance," *Policy Research Working Paper 1512*, The World Bank (1995).

¹⁶ Sec. 832(b)(4).

¹⁷ See Jon Almeras and Ryan J. Donmoyer, "Insurers Approach Congress to Fix 'Bermuda Loophole,'" 86 *Tax Notes* 1660, Mar. 20, 2000; Lee A. Sheppard, "News Analysis – Would Imputed Income Prevent Escape to Bermuda?," 86 *Tax Notes* 1663, Mar. 20, 2000.

¹⁸ Hearing of the Senate Committee on Finance, "Offshore Tax Issues: Reinsurance and Hedge Funds," September 26, 2007, Testimony of William R. Berkley, Chairman and CEO, W.R. Berkley

despite 2004 changes in the Federal tax law to limit the tax benefit of “inversions”¹⁹ – expatriation of a U.S. corporation or partnership to a foreign jurisdiction – and to strengthen the Treasury Department’s regulatory authority to reallocate items in related party reinsurance arrangements.²⁰ Though these changes may have made some types of transactions transferring U.S. risks to foreign reinsurers less attractive from a tax planning standpoint, reinsurance with offshore affiliates has remained strong.²¹

Insuring risks with insurance affiliates generally can have the effect of reducing U.S. tax on earnings on reserves set aside to cover losses incurred with respect to those risks. Because tax accounting rules applicable to insurance companies provide a deduction for additions to insurance reserves, investment earnings on insurance company reserves can be viewed as tax-favored.²² The bill reflects the concern that the use of affiliated reinsurers is a means by which U.S. insurance risks migrate to offshore reinsurance markets so as to avoid U.S. tax on reserve earnings. The bill consequently provides for disallowance of the deduction for premiums for reinsurance with affiliates that exceed the industry average for each line of property and casualty

Corporation: “Current law allows a U.S. member of a foreign–domiciled group to avoid paying U.S. tax on much of its domestic underwriting and investment income, merely by reinsuring its business with a related-party reinsurer domiciled in a country such as Bermuda or the Cayman Islands. By contrast, a U.S.-based insurance group must pay U.S. tax on all of its underwriting and investment income derived from writing similar domestic business.” <http://finance.senate.gov/sitepages/hearing092607.htm>. See also Susanne Sclafane, “U.S. CEO on a Mission to Tax Bermuda Competitors,” *National Underwriter Online News Service*, Nov. 20, 2006; Susanne Sclafane, “Bermuda CEO Fights Back on Tax Issue,” *National Underwriter Online News Service*, Nov. 21, 2006. In 2002, in oral testimony before the Ways and Means Committee and in written response to a question, Pamela Olson, Acting Assistant Treasury Secretary for Tax Policy, stated, “The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S. -source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transaction [sic] are not sufficient to address this situation.” Hearing of the House Committee on Ways and Means on Corporate Inversions, June 6, 2002, Serial 107-73, pages 9-10 and 26, <http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/6-6-02/107-73final.htm>.

¹⁹ Section 7874, imposing U.S. tax on certain income and gain of expatriated entities, was enacted in section 801 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

²⁰ Section 845, providing authority to the Treasury Department for allocation in the case of a reinsurance agreement involving tax avoidance or evasion, was enacted in 1984 and was modified by section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

²¹ Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market: 2008 Data*, at Table 8 (stating that “[t]he NAIC database indicates that companies in 51 jurisdictions received reinsurance premiums of \$33.2 billion from affiliated U.S. insurers in 2008....”). As shown in Table 8, the comparable volume of affiliated offshore reinsurance premiums for 2004 was \$31.1 billion.

²² Discounting rules applicable to tax reserves of property and casualty insurance companies partially take account of the time value of money (sec. 846).

insurance business with third party insurers. This approach acknowledges that reinsurance has essential risk management and other functions. At the same time, the approach is structured to discourage reinsurance transactions that are likely to be motivated by avoidance of U.S. taxation because they exceed industry norms.

The bill also provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. This election is intended to provide that these foreign affiliates are not treated less favorably than U.S. reinsurers, in the unlikely event that the bill could be viewed as discriminatory under the nondiscrimination article of any U.S. tax treaty.

Explanation of Provision

General rule

The provision disallows any deduction to covered insurance companies for excess reinsurance premiums with respect to U.S. risks paid to affiliated insurance companies that are not subject to U.S. income taxation. Thus, under the provision, the deduction for a portion of reinsurance premiums paid to affiliates may be disallowed.

Covered insurance company

A covered insurance company for this purpose is any company subject to tax imposed by section 831 of the Code. Thus, for example, a property and casualty insurance company subject to tax in the United States is considered a covered insurance company under the provision. The fact that a company subject to tax under section 831 has no tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to tax under section 831. All domestic members of a controlled group of corporations (as defined in section 1563) of which a covered insurance company is a member are treated as one corporation.

The excise tax under section 4371 is disregarded for purposes of determining whether a company is a covered insurance company. Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to tax under section 831, is not considered a covered insurance company for purposes of this provision.

Affiliated corporation

Under the provision, a corporation is treated as an affiliated corporation with respect to a covered insurance company if both corporations are members of the same controlled group of corporations. For this purpose, a controlled group of corporations is defined as in section 1563(a), except using a standard of "more than 25 percent" of the total vote or value of shares in lieu of "at least 80 percent."

Affiliated nontaxed reinsurance premiums

Under the provision, the deduction for excess reinsurance premiums is disallowed. Excess reinsurance premiums are those affiliated nontaxed reinsurance premiums paid during the

taxable year by a covered insurance company in excess of the sum of (1) the premium limitation and (2) qualified ceding commissions with respect to such premiums.

An affiliated nontaxed reinsurance premium is any reinsurance premium paid, directly or indirectly, to an affiliated corporation if, with respect to the affiliated corporation, the premium is neither subpart F income nor subject to U.S. income tax.²³ Under a netting rule, the amount that would otherwise be treated as affiliated nontaxed reinsurance premiums with respect to a covered insurance company is reduced (but not below zero) by the amount of reinsurance premiums paid directly or indirectly to that company by that affiliated corporation during the taxable year. If any treaty between the United States and a foreign country reduces the U.S. income tax imposed on the premiums, then to that extent the premium is treated for this purpose as a premium on which no U.S. income tax is imposed (as under section 163(j)(5)(B)). For purposes of determining whether the premium is subject to U.S. income tax, the excise tax imposed by section 4371 is not taken into account.

Industry fraction

The premium limitation is determined by comparing a covered insurance company's reinsurance with an industry average amount of reinsurance based on an industry fraction of reinsurance. The industry fraction is used to determine the allowable amount of affiliate reinsurance. The numerator of the industry fraction is the industry aggregate reinsurance premiums paid by covered insurance companies to nonaffiliated corporations. The denominator of the industry fraction is the aggregate gross premiums written by covered insurance companies.

The industry fraction for each calendar year is determined, and is to be published, by the Treasury Department on the basis of published aggregate data from annual statements of insurance companies. The determination of the industry fraction is made separately for each line of business. Data for the second preceding calendar year are used in determining the industry fraction so as to allow time for the publication of aggregate industry data.²⁴

Premium limitation

In determining the premium limitation for a line of its business for a taxable year, a company applies the industry fraction published by the Treasury Department for that line of business for the calendar year in which the company's taxable year begins. Under this rule, the industry fraction is multiplied by the company's gross premiums written for the line of business

²³ For this purpose, the withholding tax under sections 1441 and 1442 is taken into account.

²⁴ Insurance companies make financial reports -- annual statements -- on forms prescribed by the National Association of Insurance Commissioners and file with the insurance commissioners of the States in which the companies are licensed to do business. In determining the industry fraction, it would be appropriate for the Treasury Department to employ insurance company annual statement data compiled by, for example, A.M. Best Company (e.g., A. M. Best Company, *Best's Aggregates and Averages, 2008 Edition*, which contains data from annual regulatory filings related to 2007), which it is understood that the Treasury Department also uses to determine loss payment patterns for purposes of the discounting rules applicable to property and casualty insurers under section 846 of the Code.

for the taxable year. Reinsurance premiums assumed from nonaffiliated corporations are treated in the same manner as gross premiums written directly by a covered insurance company. The amount of the premium limitation for any line of business for the taxable year is the excess of this product over the aggregate reinsurance premiums paid by the company that are not affiliated nontaxed reinsurance premiums (generally, that are premiums paid to nonaffiliated reinsurers). This is the maximum amount that is allowed as a deduction for reinsurance paid to affiliates under the provision. The amount of the premium limitation may not be less than zero.

Application of the premium limitation does not result in the disallowance of any deduction for reinsurance premiums paid to persons that are not affiliated corporations (as defined under the provision). However, the provision operates by determining the deduction amount disallowed after taking into account premiums paid to corporations that are not affiliated. Thus, the provision disallows the deduction for reinsurance premiums paid to an affiliated corporation if the company's reinsurance premiums paid to corporations that are not affiliated exceed the amount of the company's premium limitation for that line of business.

Qualified ceding commissions

The amount of qualified ceding commissions is added to the premium limitation under the deduction disallowance rule of the provision. A qualified ceding commission for purposes of the provision is determined as a portion of the ceding commissions that are paid to a covered insurance company (and that are included in its income) with respect to the affiliated nontaxed reinsurance premiums paid by the covered insurance company during the taxable year. This portion is determined by the ratio of (i) the amount of such affiliated nontaxed reinsurance premiums paid by the company during the taxable year that exceeds the premium limitation for that year, to (ii) the aggregate amount of affiliated nontaxed premiums paid by the company that year.²⁵ Thus, under this rule, this treatment is provided for certain ceding commissions included in the taxpayer's income that are paid to the taxpayer with respect to otherwise nondeductible affiliated nontaxed reinsurance premiums. The inclusion of such ceding commissions in income offsets the potential for earnings stripping through the reinsurance transaction to the extent of the amount so included.

Election to treat specified reinsurance income as effectively connected

Nondiscrimination

Nondiscrimination articles of U.S. tax treaties generally prohibit nationals of one treaty country from being subjected to more burdensome taxation (or any connected requirement) in the other treaty country than are nationals of that other treaty country in the same circumstances. It is believed that the provision does not violate any nondiscrimination article of any applicable U.S. tax treaty.

²⁵ This calculation is to be made consistently with the applicable rules of the provision. Thus, for example, ceding commissions are determined separately for each line of business, and all domestic members of a controlled group of which a covered insurance company is a member are treated as one for this purpose.

A nondiscrimination article applies only in cases in which persons are in the same circumstances. The provision treats similarly situated persons similarly, so a nondiscrimination article would not apply. In this case, the determination of whether two corporations are in the same circumstances is properly made by reference to the U.S. income tax that those persons do or do not bear on reinsurance premiums from U.S. corporations.²⁶ For example, foreign corporations are in the same circumstances as tax-exempt entities²⁷ because generally neither bears tax on reinsurance premiums from U.S. corporations. However, foreign corporations and tax-exempt entities receiving reinsurance premiums from U.S. corporations are not in the same circumstance as taxable U.S. corporations receiving reinsurance premiums from U.S. corporations, as such payments, when made to a foreign corporation or tax-exempt entity, may remove from U.S. taxing jurisdiction the earnings on reserves set aside to cover losses incurred with respect to the reinsured risks. Such a determination is consistent with the view that payments leaving U.S. taxing jurisdiction may, in appropriate circumstances, consistent with U.S. tax treaties, be subjected by the United States to tax that would not be imposed on a payment to a U.S. person.

U.S. tax treaties generally provide that the nondiscrimination article does not apply in certain cases involving transactions between related persons. One of these circumstances arises in cases in which paragraph 1 of Article 9 (Associated Enterprises) of a U.S. tax treaty applies. That paragraph applies in cases in which an enterprise of a treaty country is related to an enterprise of the other treaty country, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship.²⁸ The provision sets forth a standard for determining reinsurance premiums in an arm's-length fashion. Thus, any reinsurance premiums that are disallowed under the provision do not, by definition, satisfy the arm's-length standard and may properly be disallowed under U.S. tax treaties.

Operation of the election

Finally, the provision provides an election for a foreign corporation to treat certain premiums and certain net investment income as subject to tax for U.S. income tax purposes. The election provides that a specified affiliated corporation may elect for any taxable year to treat specified reinsurance income as effectively connected with the conduct of a trade or business in the United States, and to be treated as carrying on an insurance business within the United States. Thus, an electing company is subject to the rules of present-law section 842 governing effectively connected income of foreign insurance companies carrying on an insurance business in the United States. As under present law, for purposes of this election, deductions are allowed

²⁶ Thus, the provision makes no distinction between foreign insurance companies on the basis of whether or not their reinsurance premium income is subject to tax in their residence country.

²⁷ See sec. 501(c)(8) and (15).

²⁸ United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 24, par. 4; Art. 9, par. 1.

only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States.

For purposes of this election, a specified affiliated corporation eligible to make the election is defined as an affiliated corporation that meets several requirements. First, it must be a foreign corporation that would qualify as a life insurance company or a property and casualty insurance company for Federal income tax purposes if it were a domestic corporation.²⁹ Second, it must waive all benefits granted by the United States under any treaty between the United States and a foreign country with respect to specified reinsurance income to which the election applies.³⁰ Lastly, it must meet any requirements prescribed by the Treasury Department to ensure that U.S. tax on the specified reinsurance income is properly determined and paid. In prescribing these requirements, the Treasury Department is directed to strictly ensure that, for purposes of determining net investment income, only those deductible items directly allocable to gross investment income that is allocable to the specified reinsurance premiums are allowed.

For purposes of the election, specified reinsurance income means, with respect to any taxable year, (1) all reinsurance premiums that would (but for this election) be affiliated nontaxed reinsurance premiums (as defined under the provision) and that are received by a corporation during the taxable year directly or indirect from covered insurance companies with respect to which the corporation is affiliated, and (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums with respect to which an election applies (whether for the current or a prior taxable year).

If a specified affiliated corporation is an affiliate of more than one covered insurance company, the election applies with respect to all such covered insurance companies. The election may be revoked only with the consent of the Secretary.

Regulatory authority

The provision grants regulatory authority to carry out or to prevent the avoidance of the purposes of this provision. In particular, the Treasury Department is directed to identify, and prevent avoidance of the provision through, transactions that are alternatives to traditional reinsurance, through fronting transactions, conduit and reciprocal transactions, and through any economically equivalent transactions. The Treasury is directed to publish guidance relating to prevention of avoidance of the purposes of the provision as promptly as possible, and is directed to make such guidance effective at a time consonant with the statutory effective date.

²⁹ Present-law rules providing that a foreign corporation is not an includable corporation for purposes of an affiliated group filing a consolidated return continue to apply (secs. 1502, 1504(b)(3)). Thus, specified reinsurance income (or loss, if any) of an electing company cannot be taken into account on a U.S. consolidated return.

³⁰ Because an electing company must waive all treaty benefits granted by the United States with respect to the specified reinsurance income, the reasoning of the *North West* case, above, which interpreted a treaty provision to prevent the application of the section 842(b) calculation of minimum effectively connected net investment income, does not apply.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.